Select Committee on Pension Policy

P.O. Box 40914
Olympia, WA 98504-0914
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October 27, 2005

2:00 pm - 4:00 pm
House Hearing Room C

Plan 1 Unfunded Liability Subgroup

AGENDA

(1) **Approval of Minutes**

(2) **Reports on Revenue Forecasts/Impacts**
- Local Sources - Glenn Olson
- State Non-GFS - Victor Moore

(3) **Phase-In Proposals - Matt Smith, State Actuary**

(4) **Rate Floor with Target Funding Ratio - Matt Smith**

(5) **Next Steps**

SCPP and voting members: *Victor Moore (chair); Senator Craig Pridemore; Representative Barbara Bailey; Glenn Olson.*

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Select Committee on Pension Policy

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PLAN 1 UNFUNDED LIABILITY SUBGROUP
DRAFT MINUTES

October 3, 2005

The Plan 1 Unfunded Liability Subgroup met in House Briefing Room, Olympia, Washington on October 3, 2005.

SCPP and Voting Members:

Victor Moore, Chair
Senator Craig Pridemore
Representative Bailey by phone
Glenn Olson

Victor Moore, Chair, called the meeting to order at 2:14 PM.
Chair Moore discussed the duties of the subgroup.
Chair Moore handed out and reviewed the "Six Year Outlook" table.

(1) Review of Options

- Option 2 - Resume Plan 1 UAAL payments
- Option 4 - Phase-in a step up of UAAL rates
- Option 5 - Establish rate floor with target funding ratio

Matt Smith, State Actuary, presented the report entitled "Review of Options." Discussion followed.

(2) Role of SCPP - Discussion

The subgroup decided to pursue specific recommendations and requested that staff prepare several phase-in options to be presented at the next subgroup meeting.

(3) Next Steps

Staff was asked to poll the members for their availability for a meeting prior to the November 15, 2005 SCPP Full Committee meeting.

The meeting adjourned at 4:00 PM.

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Rate Phase-In Proposals

(October 14, 2005)

Phase-In Proposals

- **Current Law** - no rate phase-in; full Plan 1 UAAL rates resume at the beginning of the 2007-09 biennium
- **1-Year Catch Up** - full 2005-07 payment made during 2006-07; no phase-in thereafter
- **2-Year Phase-In** - rate increases over 2006-08 with the same present value as current law over a 2-year phase-in period
- **3-Year Phase-In** - rate increases over 2006-09 with the same present value as current law over a 3-year phase-in period
- **4-Year Phase-In** - rate increases over 2006-10 with the same present value as current law over a 4-year phase-in period

Plan 1 UAAL Rate Phase-In Schedules*

	2006-07	2007-08	2008-09	2009-10	2010-11
PERS 1					
Current Law	0.00%	2.63%	2.63%	3.13%	3.13%
1-Yr Catch Up	3.54%	2.38%	2.38%	2.88%	2.88%
2-Yr Phase-In	0.87%	1.75%	2.63%	3.13%	3.13%
3-Yr Phase-In	0.87%	1.75%	2.63%	3.13%	3.13%
4-Yr Phase-In	0.84%	1.68%	2.51%	3.35%	3.13%
TRS 1					
Current Law	0.00%	3.85%	3.85%	5.21%	5.21%
1-Yr Catch Up	4.16%	3.55%	3.55%	4.91%	4.91%
2-Yr Phase-In	1.28%	2.54%	3.85%	5.21%	5.21%
3-Yr Phase-In	1.29%	2.55%	3.83%	5.21%	5.21%
4-Yr Phase-In	1.29%	2.58%	3.86%	5.15%	5.21%

**All rates shown in this exhibit exclude the cost of future gain-sharing benefits.*

Total Employer Rates under Phase-In Schedules*

	2006-07	2007-08	2008-09	2009-10	2010-11
PERS					
Current Law	3.50%	6.69%	7.37%	7.33%	7.33%
1-Yr Catch Up	7.04%	6.44%	7.12%	7.08%	7.08%
2-Yr Phase-In	4.37%	5.81%	7.37%	7.33%	7.33%
3-Yr Phase-In	4.37%	5.81%	7.37%	7.33%	7.33%
4-Yr Phase-In	4.34%	5.74%	7.25%	7.55%	7.33%
TRS					
Current Law	3.25%	7.14%	7.63%	9.86%	9.86%
1-Yr Catch Up	7.41%	6.84%	7.33%	9.56%	9.56%
2-Yr Phase-In	4.53%	5.83%	7.63%	9.86%	9.86%
3-Yr Phase-In	4.54%	5.84%	7.61%	9.86%	9.86%
4-Yr Phase-In	4.54%	5.87%	7.64%	9.80%	9.86%

**All rates shown in this exhibit exclude the cost of future gain-sharing benefits and exclude an administrative expense rate of 0.19%.*

Fiscal Impact of the Phase-In Schedules

Costs (in Millions):	1-Yr Catch Up	2-Yr Phase-In	3-Yr Phase-In	4-Yr Phase-In
2006-2007				
State:				
General Fund	$176.0	$50.2	$50.2	$49.8
Non-General Fund	$78.5	$19.3	$19.3	$18.6
Total State	**$254.5**	**$69.5**	**$69.5**	**$68.4**
Local Government	$200.0	$52.9	$52.9	$51.9
Total Employer	$454.5	$122.4	$122.4	$120.3
Total Employee	$0.0	$0.0	$0.0	$0.0
2007-2008				
State:				
General Fund	($14.6)	($58.7)	($58.4)	($59.2)
Non-General Fund	($7.0)	($24.8)	($24.8)	($26.7)
Total State	**($21.6)**	**($83.5)**	**($83.2)**	**($85.9)**
Local Government	($16.7)	($62.7)	($62.5)	($65.5)
Total Employer	($38.3)	($146.2)	($145.7)	($151.4)
Total Employee	$0.0	$0.0	$0.0	$0.0

Costs (in Millions):	1-Yr Catch Up	2-Yr Phase-In	3-Yr Phase-In	4-Yr Phase-In
2008-2009				
State:				
General Fund	($15.4)	$0.0	($0.8)	($2.7)
Non-General Fund	($7.4)	$0.0	($0.3)	($3.6)
Total State	**($22.8)**	**$0.0**	**($1.1)**	**($6.3)**
Local Government	($17.7)	$0.0	($0.8)	($6.2)
Total Employer	($40.5)	$0.0	($1.9)	($12.5)
Total Employee	$0.0	$0.0	$0.0	$0.0
2009-2010				
State:				
General Fund	($16.3)	$0.0	$0.0	$3.9
Non-General Fund	($7.9)	$0.0	$0.0	$6.9
Total State	**($24.2)**	**$0.0**	**$0.0**	**$10.8**
Local Government	($18.6)	$0.0	$0.0	$11.3
Total Employer	($42.8)	$0.0	$0.0	$22.1
Total Employee	$0.0	$0.0	$0.0	$0.0
2010-2011				
State:				
General Fund	($17.1)	$0.0	$0.0	$0.0
Non-General Fund	($8.3)	$0.0	$0.0	$0.0
Total State	**($25.4)**	**$0.0**	**$0.0**	**$0.0**
Local Government	($19.8)	$0.0	$0.0	$0.0
Total Employer	($45.2)	$0.0	$0.0	$0.0
Total Employee	$0.0	$0.0	$0.0	$0.0

Rate Floor with Target Funding Ratio

(October 17, 2005)

Example

The following are excerpts from HB 1324 (2005 session) and provide an example of a rate floor with a target funding ratio that was included in last year's SCPP proposal:

> *"Beginning July 1, 2009, an additional minimum 2.75 percent is added to the minimum employer contribution rate of 4.00 percent for the public employees' retirement system until the actuarial value of assets equals one hundred 125 percent of the actuarial accrued liability for the public employees' retirement system plan 1 or June 30, 2024, whichever comes first."*

> *"Upon completion of each biennial actuarial valuation, the pension funding council and the state actuary shall review the appropriateness of the minimum contribution rates and the pension funding council shall recommend to the legislature any adjustments as may be needed due to material changes in benefits or actuarial assumptions, methods, or experience."*

Purpose of a Rate Floor with a Target Funding Ratio

Rate Floor

The addition of a rate floor under current Plan 1 funding policy would:

- eliminate a potential form of rate escalation at the end of the scheduled amortization period;
- stabilize future rates; and
- improve the adequacy of Plan 1 unfunded actuarial accrued liability (UAAL) rates over the long-term.

Under current funding policy, employer contribution rates necessary to amortize the Plan 1 UAAL by June 30, 2024 fluctuate based on the results of a biennial actuarial valuation. There is currently no statutory floor rate in place and contributions to the PERS 1 and TRS 1 UAAL have been suspended since the beginning of the 2003-05 biennium.

Under current funding policy, Plan 1 UAAL rates decrease as Plan 1 funded status improves and increase as funded status weakens. Short-term fluctuations in Plan 1 UAAL rates are largely based on short-term investment performance and directly correlated with the plan's asset allocation policy. Riskier assets classes, with the reward of higher long-term investment return and lower long-term plan costs, will produce more volatile investment returns in the short-term. Asset smoothing techniques help dampen rate volatility, but on their own cannot eliminate rate volatility entirely during periods of extraordinary investment performance.

In the absence of a rate floor, Plan 1 UAAL rates will decrease below expected long-term levels during periods of extraordinary investment performance and then return to expected long-term levels after the downward cyclical investment markets that historically follow. Given the fixed statutory amortization date of June 30, 2024, any premature reduction of Plan 1 UAAL contribution rates in the short-term will lead to escalating Plan 1 UAAL contribution rates at the end of the amortization period.

A Plan 1 UAAL rate floor will eliminate this type of potential escalation in rates, stabilize future rates and improve the adequacy of Plan 1 UAAL rates over the long-term.

Funding Target

The addition of a funding target under current Plan 1 funding policy would serve two purposes:

- increase the likelihood that once amortized, future contributions to the Plan 1 UAAL would not be required; and
- ensure that the floor contribution rates do not produce an excessive asset reserve.

A target funding ratio would be attained when the plan's assets divided by the plan's actuarial accrued liability exceeds a target percentage - say 140 percent. The assets would be calculated under the current asset smoothing method and the liabilities would be calculated under current assumptions and methods for determining on-going contribution requirements.

A plan that is exactly 100 percent funded on a particular valuation date may require additional contributions in the future. The key is understanding the purpose of the measurement and the assumptions used to determine the funded status under that measurement.

The following is an excerpt for the 2003 actuarial certification letter:

> *"The primary purpose of this valuation is to determine contribution requirements for the systems listed above as of the valuation date and should not be used for other purposes."*

The purpose of this statement is to inform the reader that the valuation results will vary depending on the intended purpose of the measurement. Is the reader seeking contribution requirements for an open and on-going plan? Seeking the lump-sum contribution required to settle the plan's unfunded liabilities under a closed plan? Perhaps the reader would like to know the contribution rate required to completely amortize the Plan 1 UAAL by 2024 and be reasonably assured that no future contributions would be required under current plan provisions?

Clearly, the results of a single actuarial valuation cannot accommodate all of the purposes listed above. Each measurement requires a unique set of actuarial assumptions and methods that produces materially different results.

Under current funding policy, the Plan 1 UAAL rate is calculated using assumptions that model expected long-term economic and demographic conditions over an extended measurement period - say 30 to 40 plus years into the future. However, the current amortization date is June 30, 2024 - less than 20 years from today. Applying an interest rate assumption over a period shorter than the intended measurement period (i.e., the duration of the amortization period is less than the duration of the measurement period for all plan liabilities) increases the likelihood that the interest assumption will not be achieved over the remaining amortization period. As a result, it is more likely than not that contributions to the Plan 1 UAAL will be required after June 30, 2024.

One way of addressing this situation is to tie the Plan 1 UAAL amortization policy to a target funding ratio. This would avoid a separate and distinct measurement of the Plan 1 UAAL. Under a target funding ratio, contributions to the Plan 1 UAAL would continue until a "target reserve" is established and the target reserve would decrease the likelihood that further contributions would be required following the amortization period.

Combining the target funding ratio with the rate floor provides a form of a "check and balance" between these two policies. A rate floor without a target funding ratio could produce an excessive asset reserve and unnecessarily increase plan costs. A funding target without a floor contribution rate would likely not be attained.

Appropriate Level of Floor Rates

The selection of an appropriate rate floor requires actuarial judgement and actuarial projections. Certainly, the selection of any rate floor will improve the rate stability issues mentioned previously. However, the improvements from such a funding policy change would diminish as the level of the rate floor decreases as a percentage of the long-term expected contribution rate. A floor contribution rate between 80 and 100 percent of the expected long-term rate would be appropriate for this purpose. This would correspond with rates between 2.68 and 3.35 percent for PERS 1 and rates between 4.71 and 5.89 percent in TRS 1. (Note: these rates exclude the cost of future gain-sharing benefits).

Appropriate Target Funding Ratio

The selection of an appropriate target funding ratio also involves actuarial judgement. A funding target closer to 100 percent could produce an insufficient reserve for the purposes stated above. On the other hand, a target ratio in excess of 150 percent may produce an excessive reserve and unnecessarily increase the long-term cost of the plan. An excessive reserve could also lead to increased demand for benefit enhancements - further increasing the long-term cost of the plan.

Federal law concerning minimum funding requirements for qualified retirement plans in the private sector provides some insight on this topic. Prior to the passage of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001, the full funding limit credit under Section 412 of the Internal Revenue Code (IRC) was based on 150 percent of the plan's current liability. This was increased to 170 percent (for plan years beginning in 2003) following the passage of EGTRRA. The provisions of EGTRRA are set to expire for plan years beginning after December 31, 2010. Section 412 of the IRC does not apply to governmental plans, but does provide one point of reference in regards to full funding.

A funding target of 125 to 150 percent would be appropriate. The State Actuary recommends a funding target of 125 percent.

Summary

The addition of a Plan 1 UAAL rate floor tied to a target funding ratio would:

- eliminate a potential form of rate escalation at the end of the scheduled amortization period;
- stabilize future rates;
- improve the adequacy of Plan 1 UAAL rates over the long-term;
- increase the likelihood that once amortized, future contributions to the Plan 1 UAAL would not be required; and
- ensure that the floor contribution rates do not produce an excessive asset reserve.

The State Actuary recommends a floor contribution rate between 80 and 100 percent of the expected long-term rate. This would correspond with rates between 2.68 and 3.35 percent for PERS 1 and rates between 4.71 and 5.89 percent in TRS 1. (Note: these rates exclude the cost of future gain-sharing benefits).

The State Actuary recommends a funding target of 125 percent.

Next Steps

The subgroup will need to select floor PERS 1/TRS 1 UAAL rates (and decide whether or not to include the cost of future gain-sharing benefits) and select a target funding ratio. Staff will then prepare draft bill language for the full committee.

Review of Options

Select Committee on Pension Policy
Plan 1 Unfunded Liability Subgroup

October 3, 2005

Matt Smith, EA, FCA, MAAA
State Actuary

Options From Executive Committee

- Option 2
  - Resume Plan 1 UAAL payments based on revenue forecast gains.
- Option 4
  - Phase in a step of UAAL rates.
- Option 5
  - Establish rate floor with target funded ratio.

Option 2

- Unanswered questions:
  - How much money is available?
  - Who pays?
  - How is the money collected?

How Much Money?

- Revenue forecast revision in September is an increase of $492.9 million.
  - Additional forecasts in November and February
- Are local and other revenue sources also improving?
  - Local government revenue is largely property-tax based (with caps on rate of increase); and
  - Non-general fund state revenue is more fixed fee based.

How Much Money?

- What is the priority for pensions as it relates to other budget priorities?
  - The ultimate decision rests with the legislature.
  - $173 million in GF-S ($488 million all sources) payments were required for 05-07 before suspension.
  - 03-05 payments were also skipped.

Who Pays?

- All employers
  - Assumes all employers have had revenue improvements.
  - Assumes local and state non GF-S will have adequate time to modify budgets.
  - All employers would pay their proportionate share.
- State only
  - Could lead to direct subsidy of future local government and state non GF-S payments.

How is the Money Collected?

- Reinstate employer contribution rate
  - All employers or state only.
  - Rates cannot be split by state GF-S and state non GF-S.
  - TRS rates cannot be split (local vs. state).
- Lump sum GF-S appropriation
  - Excludes local government and state non GF-S

Fiscal Analysis

- For the PERS 1 unfunded liability, each $100 million collected in the '07 fiscal year will save:
  - $117 million in interest through 2024 (all funds).
  - $3.7 million in the 07-09 biennium (GF-S only).
- For TRS 1, each $100 million collected saves:
  - $106 million in interest through 2024 (all funds).
  - $10.7 million in the 07-09 biennium (GF-S only).

Fiscal Analysis

- A 1 percent Plan 1 UAAL rate in PERS and TRS for FY '07 would generate:
  - $47.4 GF-S impact ($21.2 million in PERS); and
  - $60.3 million local government impact ($45.7 million in PERS)

Decision Variables

- Who pays?
- How is it collected?
- The timing is assumed to be the beginning of the next fiscal year

Decision Matrix for Option 2

Who?	How? Contribution Rate	How? GF-S Appropriation
All Employers	▪ Avoids subsidy ▪ Assumes added revenue for all ▪ Assumes time for non GF-S budgeting	▪ N/A
State Only	▪ Impacts state non GF-S employers ▪ Ongoing split rates after FY '07 to avoid local gov't subsidy ▪ Administrative change	▪ GF-S impact only ▪ Future subsidy for local and state non GFS ▪ Inefficient use of GF? ▪ No administrative change

Option 4

- Unanswered questions:
  - What is the appropriate length/cost of the phase in?
  - Should there be a "catch-up" within the phase-in period to avoid long-term impact?
  - With or without gain-sharing?

Where are Rates Headed?

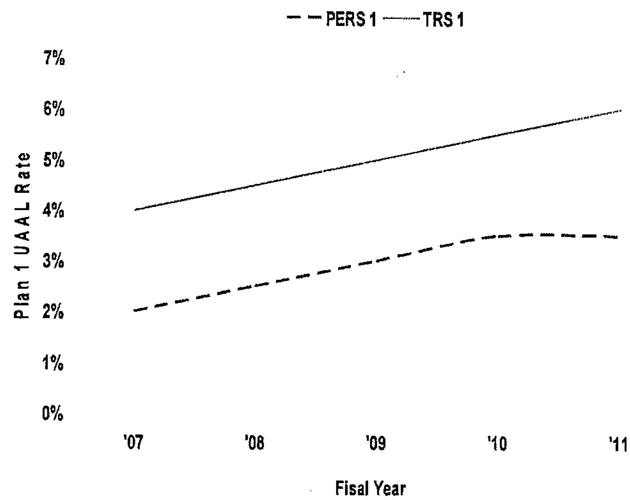
- Projection of an ultimate PERS 1 UAAL rate of 3.35 percent starting in 2011-13
- 5.89 percent in TRS 1 starting in 2011-13
  - Note: Ultimate rates exclude the cost of future gain-sharing benefits.

Length of Phase-In?

- Length will depend on the payment amount in FY '07 (option 2).
- How quickly can PERS employers step into an additional rate of around 3.5 percent?
- How quickly can TRS employers step into an additional rate of around 6 percent?
  - Note: These rates are not the total rates
    - Excludes the Plan 2/3 normal cost rate

Phase-In Example

(without future gain-sharing)



With or Without Gain-Sharing?

- If gain-sharing continues, UAAL rates will be higher.
- If gain-sharing is traded off for other benefits of lesser value, UAAL rates will be reduced.
- If gain-sharing is repealed, UAAL rates will be even lower.

Cost of Phase-In?

- The cost will depend on several factors:
  - Length of phase-in;
  - Amount of payment in FY '07 (Option 2);
  - Whether the phase-in period includes a "catch-up" payment(s) to avoid long-term interest costs; and
  - Whether gain-sharing costs are included.
- The cost will be determined after these questions are answered.

Decision Variables

- Assumptions:
  - Gain sharing will be addressed by the legislature.
  - Subgroup will move forward without gain-sharing costs (better than no phase-in).
  - Coordinated with option 2.
- Length of phase-in?
- Include catch-up payments during phase-in?

Decision Matrix for Option 5

Phase-In Length	Catch-up Payment? Yes	Catch-up Payment? No
Shorter	▪ Lowest long-term cost ▪ Highest short-term cost ▪ Avoids long-term interest cost ▪ Rate decrease after catch-up	▪ Lower long-term cost ▪ Higher short-term cost ▪ Long-term interest cost ▪ Avoids rate decrease after catch-up
Longer	▪ Higher long-term cost ▪ Lower short-term cost ▪ Avoids long-term interest cost ▪ Rate decrease after catch-up	▪ Highest long-term cost ▪ Lowest short-term cost ▪ Long-term interest cost ▪ Avoids rate decrease after catch-up

Option 5

- Unanswered questions:
  - What is an appropriate long-term floor rate?
  - What is an appropriate target funded ratio?
  - With or without gain-sharing costs?
  - Effective date?

Example

- The Plan 1 UAAL rate shall not be less than x percent until:
  - The funded ratio exceeds the target; or
  - The amortization date, whichever comes first.

Judgment Call

- The selection of the floor rates and the target funded ratio require actuarial projections and judgment.

Recommendation

- Funding target of 125 percent.
- Floor rate for PERS 1:
  - 3.00 percent (with gain-sharing)
  - 2.75 percent (without gain-sharing)
- Floor rate for TRS 1:
  - 5.50 percent (with gain-sharing)
  - 4.75 percent (without gain-sharing)
- Effective date coordinated with phase-in.

Next Steps?

- Subgroup report to full SCPP in October.
- Subgroup to finalize recommendation(s) before November SCPP meeting.
- Final subgroup report to full SCPP in November.

Washington State
School Retirees Association

4726 Pacific Ave. SE   Lacey, WA 98503-1216 • PHONE (360) 413-5496

MEMORANDUM

RECEIVED
OCT 24 2005
Office of
The State Actuary

TO: Select Committee on Pension Policy (SCPP) Plan 1 Unfunded Liability Subgroup
Victor Moore, Chair
Senator Craig Pridemore
Representative Barbara Bailey
Glenn Olson – PERS Employer Representative

FROM: Robert Rhule, WSSRA Legislative Committee Chair
Leslie Main, WSSRA Legislative Coordinator

DATE: October 20, 2005

RE: Calculation of Unfunded Liability Costs

The Washington State School Retirees' Association (WSSRA) has a long and consistent record of advocating responsible pension funding, particularly with respect to amortization of the TRS/PERS Plan 1 Unfunded Liability. Accordingly, we are very appreciative and interested in the SCPP's desire to put forth a recommendation to the Legislature as to the resumption of payment toward this important employer obligation. It was our original understanding that the Plan 1 Unfunded Liability Subgroup was charged with analysis of the technical aspects of options related to the Unfunded Liability; the results of which would then be communicated to the full SCPP for their use in developing a policy recommendation. We are now aware that the Subgroup has decided to put forth a policy recommendation to the full SCPP.

WSSRA understands that payment of the TRS/PERS 1 Unfunded Liability represents a challenge to General Fund-State (GF-S), non-GF-S, and local government employers alike. However, it is our concern that omission of future Gain Sharing costs from a policy recommendation of the Plan 1 Unfunded Liability Subgroup would not fully represent total material liabilities of the TRS/PERS 1 pension funds. A case could be made that enactment of ESHB 1044 by the Legislature during the 2005 Session justifies omission of Gain Sharing costs from calculation of Unfunded Liability contributions during the remainder of the 2005-07 biennium. Nonetheless, it is the strong belief of WSSRA that until the Legislature takes definitive action on Gain Sharing, the costs of future Gain Sharing disbursements resulting from currently established statute should be accounted for in any calculation of Unfunded Liability obligations from 2007-09 and beyond.

Aside from the fiscal ramifications, WSSRA is also concerned about the policy implications of omitting the costs of future Gain Sharing disbursements from any recommendation of the Plan 1 Unfunded Liability Subgroup. We understand that some parties may hope to see a repeal of Gain Sharing benefits without any replacement benefits and thus realize only savings to employers. However, such a total "take away" of Gain Sharing benefits by the Legislature is not a forgone conclusion that should be utilized in the development of a policy recommendation dealing with resumption of employer payments toward the Plan 1 Unfunded Liability.

WSSRA therefore requests that any policy recommendation put forth by the Plan 1 Unfunded Liability Subgroup to the full SCPP be accompanied by cost estimates which include the cost of future Gain Sharing benefits. Thank you for your consideration of these important issues.

cc: Representative Bill Fromhold, SCPP Chair
Senator Karen Fraser, SCPP Vice-Chair
Matt Smith, State Actuary